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I N T E R - O F F I C E C O R R E S P O N D E N C E

Richmond, Virginia

To: .Strategic Planning Committee Date: May 27. 1987
From: .R N. Ferguson and M. Waugh
Subject: .Social-Political Context of Cigarette Sales and Use
 in the U.S. - 1987

The major resource for our input to you on the challenges facing our industry was Mr. Jack Nelson, New York Office of P.M, who provided us with much of the information on which the following sections are based.

At this point in time there appear to be five major issue areas facing the cigarette industry. These areas, listed below, will each be discussed in the following sections.

1. Social acceptability and the increased restrictions which are accompanying decreased acceptability
2. Product liability
- 3 Cigarette taxation
4. Advertising and promotion issues
5. Self-extinguishing cigarette

1. Social Acceptability

Almost all cigarette usage occurs in a social context, so that the degree of acceptability of smoking to others becomes the major issue from which pressures on the individual smoker ultimately originate. A product used in a social context can become unacceptable if it violates social mores or if it entails a level of risk intolerable to others.

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There is convincing evidence that the public perception of risk in general has heightened, due perhaps to major changes in the structure of society - weakened religion, health crazes, aging population. etc. Whatever the root causes, smoking is now perceived as a health risk to non-smokers. The following Roper data undoubtedly underestimates the state of affairs in 1987, but shows the trend.

	<u>1978</u>	<u>1982</u>	<u>1984</u>
Segregate Smokers/Non-Smokers in Eating Places	73%	84%	90%
Segregate Smokers/Non-Smokers in Work Places	61%	65%	68%
Ambient Smoke Probably Hazardous to Non-Smokers	58%	65%	68%
Smokers <u>frequently</u> uncomfortable smoking around others	13%	14%	18%

When this is coupled with the fact that smokers are a non-militant, shrinking minority, it is easy to discern why zealots and politicians can use them for "target practice" with little concern.

From the social acceptability issue, which is founded largely on the purported harm of ETS to the non-smoker, have proceeded the restriction measures. The following summary table indicates that these legislative measures are meeting with increasing success.

Smoking Restriction Bills	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Debated	158	155	165	207	228	374	387
Enacted	32	45	44	67	66	80	149

These laws are focused on the state and local level - workplace or restaurants in general. The full page TI table attached at the end of this memo shows the diverse effects of such laws on a state by state basis. In addition to this, ~50% of employers surveyed had or were considering workplace smoking restrictions. It is of concern that large numerical advances in workplace/restaurant bans are being made in nationwide "trendsetter" states such as California.

Since the current decrease in social acceptability, and all the negatives it entails, is based on the powerful ETS weapon, we have also enclosed a one page summary on this subject, prepared by the Philip Morris Corporate Affairs Department, as a second attachment to this memo. It is apparent that the effects of ETS on others is now the most

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powerful anti-smoking weapon being employed against the industry.

2. Product Liability

Almost half of the 130 pending product liability suits involved Philip Morris and thus this issue is of substantial interest to us. Apparently most of the suits fall in one or more of three categories of legal arguments.

- A. Product dangers and failure to warn of the dangers.
- B. Undermining the required warning - by various forms of promotion and by challenging health data.
- C. Causality of illness and addiction to the product such that stopping became impossible.

In the unlikely (but possible) event of plaintiffs winning some of these cases, a deluge of suits would be spurred on by "hungry" lawyers. It is possible that at some point in time a significant portion of the retail sales price of cigarettes would be required to fund these suits and related damage awards; i.e., a significant price increase would be necessary.

The only encouraging trend here is the general public revolt against large damage awards and the movement to reform state laws on liability.

3. Cigarette Taxation

This is a complicated but critical issue. Cigarettes are not only taxed at the federal level but at the state and possibly local level. To the extent that governmental bodies tend to regard this tax as a "cash flow", there is a degree of reluctance to destroy the industry. Also, many realize this is a very regressive tax, which tends to restrain some legislators (except the zealots). The problem with tax increases is that it can, under certain circumstances, decrease consumption, just as desired by the social engineers proposing these increases.

It is a fact of life that the State and Federal Excise taxes move in only one direction--up. The average state tax rate table below suggests that a large federal increase is more of a problem than the generally smaller increases enacted at the state and local level in the last few years. The federal budget deficit, and the lack of vigorous opposition from the White House, makes a federal excise tax increase a real possibility in the near future.

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State
Average Tax Rate

Current	18.25
June 30, 1986	17.32
June 30, 1985	15.77
June 30, 1984	15.44
June 30, 1983	14.54

A separate but related issue is the pressure from some quarters to replace the current excise tax with an Ad Valorem tax - an incremental percentage of the sale price. This is a serious issue for one competitive reason - it would tend to increase the price advantage of the generic versus full margin markets. Hawaii is the only state at present with such a tax.

4. Advertising and Promotion

The cigarette industry accepted a total ban on television and radio advertising in 1972. Opponents of cigarette use have convinced themselves (and some others) that a total ban on advertising would undermine the industry. It is by no means certain that the Supreme Court would not uphold such a law, despite the commercial speech interpretation of the First Amendment.

The anti-smoking effort rests on a number of assertions, such as:

- a) Cigarettes are more heavily advertised than any other product.
- b) This heavy advertising induces non-smokers, especially young people, to smoke.
- c) Taxpayers subsidize tobacco ads.
- d) Ads are deceptive since they lower awareness of health risks.

Each of these arguments can be rebutted by facts, but it is of some concern that there is a moderate level of support for such bans. A total ban would be particularly damaging since it would channel competitive forces into areas such as low price and could possibly destabilize current market shares. Such proposals at the state and local level are making very little progress.

Another aspect of cigarette promotion is state and local sampling laws. Since 1966, 14 states have considered sampling ban bills, but none has banned sampling to adults. There have been some local level actions to ban sampling even to consenting adults. The number of these restrictions at

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present, in comparison to other industry challenges, does not present a major issue.

5. "Self-Extinguishing"

Cigarettes continue to be associated with a large number of fires, many of which cause loss of life and property. It is not known if the technology exists to make cigarettes self extinguish, but this does not prevent a number of states from at least considering legislating such a product into existence. The federal feasibility study, mandated by Congress in 1984, has slowed down activity at the state level in the last three years.

On October 30, 1987, the study groups final report is due. Depending on this report, there could be actions at either the federal level or worse, numerous differing state level regulations.

If legislation is passed, it would probably be necessary to modify several aspects of current cigarette construction. This could have a negative impact on per unit costs. Of more concern, it would be hard to maintain the subjective acceptability of our major brands if design changes were legislated into these products. This is particularly unfortunate since there is really little reason to expect any increase in fire safety without some nationwide effort to treat fabrics with fire retardant chemicals.

Summary

The increased success of anti-smoking forces at undermining the social acceptability of smoking is a real and present challenge for our industry. Rebuttal is crucial but reversal of the flow of events depicted here is unlikely. This gloomy picture of 1987 and beyond must be interpreted in terms of opportunity as well as challenge. The very importance of the above issues suggest that products which can successfully address some or all of these needs can still be very successful. A threat to the industry can be an opportunity for the company which can find consumer acceptable answers to the types of challenges discussed in this memo.

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Enclosures

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